

EconoFact Chats: Cross Purposes in Dollar Policies

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I'm Michael Klein, executive editor of EconoFact, a non-partisan web-based publication of The Fletcher School at Tufts University. At EconoFact, we bring key facts and incisive analysis to the national debate on economic and social policies, publishing work from leading economists across the country. You can learn more about us and see our work at www.econofact.org.

Michael Klein

This summer, the United States Treasury joined Japanese financial authorities in an intervention in the foreign exchange market to prop up the value of the yen. Last year, the Treasury created a currency swap line to support the Argentine peso. The reasons behind supporting the peso and the yen were very different, as were the outcomes. The unprecedented direct purchase of pesos in the Buenos Aires market provided the bridge to a Milei victory that Treasury Secretary Scott Bessent had predicted. But the efforts to bolster the value of the yen were not successful. Professor Maurice Obstfeld of UC Berkeley and the Peterson Institute for International Economics has written about the economic and political aspects of both of these efforts. His work highlights the tensions that arise with foreign exchange intervention, some of which are directly linked to the politicization of policies. Maury is widely recognized as one of the world's leading experts in international economics. He has served as a member of President Obama's Council of Economic Advisers. And from 2015 to 2018, he served as Chief Economist at the International Monetary Fund. Maury, welcome back to EconoFact Chats.

Maurice Obstfeld

It's a pleasure to be here again with you, Michael.

Michael Klein

Well, it's great to have you once more. Maury, you recently wrote a blog for the Peterson Institute for International Economics with the title "In trying to prop up the yen, the U.S. wants to have its cake and eat it too." What's the tension that's reflected in wanting to have both the cake and to eat it?

Maurice Obstfeld

I wrote the blog because I thought there were three areas in which the Treasury is pursuing potentially inconsistent goals. And I think putting them all together was illustrative of some of the problems with U.S. policy right now. One issue in the intervention is that the Treasury would like the yen to be stronger, even though the U.S. has been pursuing a very aggressive tariff policy against Japan. Other things equal, a U.S. tariff against Japan would cause the yen to weaken. And as part of that push, the Trump administration negotiated pledges from Japan to invest \$550 billion in the U.S. And that sort of financial inflow to the U.S. would also tend to weaken the yen and strengthen the dollar. So, the first contradiction is that their trade policy is part of what's making the yen weak, yet the U.S. is seeking to strengthen it. A second issue is the insistence by the Treasury Secretary that he's pursuing a strong dollar policy while simultaneously trying to strengthen the yen, which also weakens the dollar. In fact, there was a concern by the U.S. with weakening currencies in Asia, which make their exports more competitive, and work against the Trump administration's objective to improve the U.S. trade balance. To try to finesse this problem, rather than selling dollars to buy yen, the Treasury sold euros to buy yen, thereby weakening the euro. They did this without consulting the ECB, by the way, which was not received well by our allies in Europe. And I think the third contradiction is related to

Bessent's desire to have a strong dollar, but moreover, a dollar which remains the leading international reserve currency. At the time that Bessent intervened in the yen market, Japan was itself selling dollars for yen. It actually sold something like \$96 billion in that episode. And to the extent that those were sales of treasuries, those sales put upward pressure on treasury yields. Part of the reason that Bessent intervened in the yen was to push the yen higher without so much need for Japan to sell its Treasuries. In other words, it was a way of helping the Japanese to accomplish what they were trying to accomplish without these treasury sales, which push up U.S. treasury rates, to which the U.S. is quite sensitive at the moment. Now, the problem is if you want to be the world's leading currency, especially its reserve currency, then foreign governments are going to hold treasury bills and they will sell them when they need to. So, if it becomes a problem whenever a foreign government sells treasuries, that's contradictory to your desire to be the world's leading reserve currency. It has been a problem in a crisis context...in March 2020, for example, the COVID pandemic broke out, and many central banks were trying to liquidate treasuries. That created strains in the treasury market. And the Fed set up a repurchase facility called the FIMA facility, Foreign and International Monetary Authorities facility, to actually provide cash for foreign holdings of treasuries on a temporary basis. In his yen intervention, Bessent suggested that the Treasury could expand the size of this facility. But that facility is there for systemic financial emergencies that actually are real threats to the international monetary system, not necessarily for everyday use.

Michael Klein

I interviewed Jeremy Stein about that episode in March of 2020, and it actually worked pretty well to help calm markets. But the yen intervention didn't really work, did it? And how much did the yen actually depreciate against the dollar? Was it kind of a crisis situation, or was it a more moderate depreciation?

Maurice Obstfeld

Well, it depends what you mean by moderate. If you look at the yen's depreciation since the pandemic, it has just plummeted. If you look at its depreciation since the start of the Trump administration, it's milder, but still a magnitude that one would regard as significant. And there were signs of increasing depreciation pressures which Treasury wanted to avoid. Part of the difficulty is that other Asian currencies are weak, notably the Korean won, and that's in part because of similar trade tensions. As those that...in fact, the Japan-U.S. relationship...and President Trump is about to meet with President Xi of China. He would like to press him for a stronger yuan. And China is less willing to do that, other things being equal, if other Asian economies have weaker currencies. So there was a complex set of interrelationships. As to the success of the action, there was an immediate bounce up in the yen. It gave up some of those gains pretty quickly. It has since reverted to a stronger level, but that's in part due to the expectation that the Bank of Japan is about to raise interest rates.

Now, this is an area also where Secretary Bessent has intervened with what used to be called 'open-mouth operations,' basically predicting quite openly that the Bank of Japan would "do the right thing soon," pressing Japan very strongly to raise its interest rates, and very openly. None of that is completely new, but the aggressiveness of his tone goes beyond what we would typically have seen from Treasury Secretaries. And it's an indication of a general tendency which I think you're going to want to talk more about today for the Trump administration to intervene very forcefully in other countries, not only exchange rate affairs, but domestic economic affairs.

Michael Klein

In fact, Bessent said, like, "I am the house" or something along those lines, right? Trying to intervene and affect the value of exchange rates. And that is kind of aggressive, although, as you said, there is a long history of this. Treasury Secretary John Connally said at one point, "the dollar is our currency but your problem." So, there's a long history of these issues, right?

Maurice Obstfeld

Yeah, not exactly a high point in U.S. treatment of its allies.

Michael Klein

Although now isn't either. There is one case where intervention in major currency markets did seem to work, and that was in September 1985 in the so-called Plaza Accord. People in the current administration refer to that and sometimes talk about a Mar-a-Lago Accord. Does the Plaza Accord offer a blueprint for currency intervention that could be successful today?

Maurice Obstfeld

Well, I would cite a number of differences and also limitations of the Plaza Accord. You know, number one, the dollar in the months preceding the Plaza Accord was incredibly overvalued. It was way out of line with where it had been historically, and this was the result mainly, I would say, of the U.S. policy mix at the time, which was very expansionary fiscal policy, very tight monetary policy. It had started to come down on its own by the time the Plaza meeting happened. And that was...again, that was an accord. It was an agreement between the U.S. and its principal allies to intervene jointly to bring the dollar down to earth.

Part of the motivation was to avoid a storm of protectionist sentiment in the U.S. For those who don't remember the late 1980s, that ultimately resulted in the 1988 Omnibus Trade Bill, which strengthened the tariff authority of the U.S. government. But there was a joint desire on the part of the Reagan administration and allies to avoid protection. The allies were also firmly under the U.S. nuclear umbrella. They were facing a then seemingly powerful Soviet Union, of which the U.S. was their protector. And if you compare the situation today, there's little currency cooperation. In fact, in the yen operation, the Treasury simply disrespected the European Central Bank, whereas normally there would have been a consultation. President Trump has brought into question the strength of the U.S. security commitment to Europe. And we're not carrying out interventions to avoid protection. The interventions are in part being made necessary by protection, and the protection has been here since the beginning of the Trump administration. So, it's very different from the Plaza situation.

Michael Klein

So we've been talking about actions taken by the Treasury to affect the value of the yen, and we'll also talk about actions to try to affect the value of the Argentine peso. But there's also a role for the Federal Reserve. In a paper you wrote with Adnan Mazarei, you discussed the different roles of the Treasury and the Federal Reserve in dealing with foreign exchange issues. What role has the Fed played, and how successful has that been?

Maurice Obstfeld

Well, the issue of who has responsibility for foreign exchange is an issue everywhere throughout the world. Because clearly the foreign exchange market is a conduit for the effects of monetary policy, and its behavior influences monetary policy. But it's typically the case that while the central bank has a domestic policy mandate, which is often price stability, full employment, financial stability at home, the Treasury is in charge of foreign economic, monetary and financial relations. And the U.S. is no different in that respect.

In fact, in 1934 the Gold Reserve Act took the foreign exchange function basically away from the Fed, gave it to the Treasury, had the Fed turn over its holdings of gold, which were then a major international reserve asset, to the Treasury, and set up the Exchange Stabilization Fund, which was the vehicle that the Treasury used, for example, to intervene in Argentina. So the Treasury has statutory authority to primacy in international financial relations. That being said, starting in the early 1960s, when the U.S. was the lynchpin of the Bretton Woods system of fixed exchange rates, and the U.S. was defending the dollar's role in that system, the Treasury approached the Fed for help in carrying out those defensive operations. And ever since then, the Fed has been somewhat involved in foreign exchange operations. Typically in the past, when there was much more foreign exchange intervention by the U.S., for example, in the '80s during the Plaza period, and in the '90s...foreign exchange interventions would be agreed by the Treasury and the Fed and carried out, you know, 50-50, half by the Exchange Stabilization Fund and half by the Fed on its own account. And I should mention that the Fed is the agent for the Treasury in the foreign exchange market. So, the New York Fed carries out the transactions, but they may not be Fed transactions in the sense that they may not involve the Fed's balance sheet. But the upshot of this is that, you know, there is a Fed role in the foreign exchange market. And there's also a tension because while typically the cooperation has been harmonious, foreign exchange operations can impinge on financial conditions and monetary policy, where the Fed is supposed to be independent. And so the navigation of those issues involves a series of understandings between the Treasury and the Fed. You may or may not want to call those accords. But from time to time there have been negotiations and understandings about where the Fed's powers and responsibilities and vulnerabilities would lie in the relationship over foreign exchange operations.

Michael Klein

Well, of course, there's a lot of concern these days about the politicization of monetary policy. And there's also a lot of concern about the politicization of foreign exchange policy, just as there's concern about the way in which economic policies like tariffs are being employed for non-economic reasons. I mentioned earlier how the support of the peso was to bolster the election chances for Javier Milei. Have Fed swap lines also been used for reasons that are not tightly tied to U.S. economic motives?

Maurice Obstfeld

Well, Fed swap lines originated around and during the global financial crisis, 2007, 2008. And these are really different from the earlier swap lines that the Fed developed in the 1960s to support the dollar and the Bretton Woods system. They're referred to as liquidity swap lines. And the use of these swap lines is for lending to usually systemically important countries that need dollars to support their financial systems. Again, the U.S. dollar's central role in the international financial system means that many banks that are outside of the protective umbrella of Federal Reserve lending facilities don't have automatic access to dollars. The swap lines provide dollars to foreign central banks, which they can lend to domestic institutions that are facing financial trouble. And, while obviously the recipients of swap lines tend to be allied countries, not necessarily closely allied countries or NATO members, because the swap lines have been extended for short periods to some emerging market countries in times of crisis...the general criterion for them is that it has nothing to do with politics. It's basically that the country has a significant financial weight and interconnectedness in the global financial system, that it follows sound policies, and also that it has a strong governance framework. You wouldn't want to be lending to a country that was supporting banks that were financing international money laundering or terrorism. So, there's a very strong set of non-political criteria on the basis of which the Fed has extended these liquidity swap lines in the past. And they've evolved into a very important part of the international financial safety net.

Michael Klein

Well, what about a swap line for the United Arab Emirates? Did they really need it? Or why was that extended, do you think?

Maurice Obstfeld

You know, the UAE approached the United States authorities about a swap line last spring and soon made it clear that they didn't want a Treasury swap line, they wanted a Fed swap line. Now, I should mention that the Treasury swap lines, such as the one used to support Argentina, have very often in the past, though not recently, been used with political objectives in mind. As I mentioned, they started up in the 1930s and were widely deployed in Latin America. They were widely deployed in Latin America in the '50s as well, where a strong goal of the U.S. was to support regimes against communism. So, the political deployment of Treasury swap lines is not a new thing. It was very nakedly deployed for a political end in Argentina in 2025. But, the Treasury is carrying out the foreign policy goals of the United States, and so it's hard to argue that this is a totally illegitimate way to proceed. The Fed's swap lines are very different because whereas the Treasury has a limited amount of money it can use without additional congressional appropriation, and in principle that congressional appropriation process could provide political oversight...the Fed can create money. The swap lines it currently maintains with the five most systemic central banks, and those are the ECB, the Bank of Japan, the Bank of England, the Swiss National Bank and the Bank of Canada...those are uncapped, potentially limitless, and the Fed can create any amount of dollars that is needed. So these are very powerful tools. They're available as standing swap lines to our closest allies who have the greatest interconnections with dollar markets and foreign exchange markets generally, and who have extremely high standards of governance, who cooperate with the U.S. on financial oversight, on AML/CFT, in a range of areas.

Now the UAE is a regional financial power but has nowhere the degree of connectedness and financial weight as these other central banks. It also has massive foreign exchange reserves. I mean, massive foreign exchange reserves. And part of its reason for wanting a swap line was simply the prestige value. Its luster is not what it was given events in the Gulf, and the attacks it's been under. It's involved in a feud with Saudi Arabia. It left OPEC last spring. The two countries are battling it out with proxies in Sudan. But the UAE's standards of governance are really not up to snuff. It has been a banker effectively for some not very savory actors in the Middle East. It's been accused of laundering gold sales by the Sudanese rebels. So, there's a lot going on there. And I think if the Treasury were to push the Fed to issue a swap line to the UAE, there would be a lot of pushback within the Federal Open Market Committee.

Michael Klein

I guess that's just another example of what we've been seeing with respect to the politicization, or attempted politicization of the Federal Reserve. So Maury, you know, these are really important issues that I think are not generally very well understood by the public, or even a lot of people perhaps working in policy. But it was really good to have you explain them so clearly, and to let us understand how they are vital issues. So, thank you very much for joining me once again on EconoFact Chats.

Maurice Obstfeld

It's been a total pleasure, Michael. I hope we can do it again soon.

Michael Klein

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